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TAGS: [ECON](#) [EINV](#) [EFIN](#) [PGOV](#) [EC](#)
SUBJECT: ECUADORIAN ECONOMIC POLICIES IN 2008: LESS
RHETORIC, MORE CHANGES AND CONTINUED UNCERTAINTY

REF: QUITO 129

Classified By: Classified by Ambassador Linda Jewell. Reason: 1.4 B and D.

¶1. (C) Summary. In 2008, the Correa Administration's rhetoric on economic issues should moderate but will not disappear. However, this year the GOE will probably make more substantive changes than it did in 2007, as it actually begins to implement its economic program. Many of the changes will likely be positive or neutral, but others could be negative. Regardless of the balance, the scope of change and uncertainty about its direction will keep the private sector off balance and continue to impede investment. End summary.

¶2. (C) This cable supplements reftel, which examined Correa's economic policies in 2007. Last year the Correa administration unsettled investors with a high level of economic rhetoric, compounded by electoral politics and a less seasoned team during the government's early months. In practice, however, it implemented only a limited number of mostly pragmatic changes on the economic front.

ECONOMIC POLICY TRENDS IN 2008

¶3. (C) In 2007, the Correa government made relatively few economic policy changes as it zigzagged between its sometimes grandiose desires to implement bold change and the practical constraints of governing. However, it still intends to implement a wide range of reforms to rectify what it has identified as a series of economic shortcomings. 2007 was in part a year for the government to learn some of the limitations on its ability to effect change, but it was also a year when the government cued up a number of projects that it wants to implement this year. As a result, the GOE has a highly ambitious economic agenda for 2008, which promises to be another year with considerable economic uncertainty. Growth should pick up modestly in 2008 (between 2.5-3%) as the government improves its capacity to spend, but private sector contributions to growth will likely continue to lag amid on-going uncertainty. Unknown prospects for an additional extension of Andean Trade Preferences, currently on track to be extended only through December 2008, will add to investor caution in many export-driven sectors.

Moderating Rhetoric

¶4. (C) Compared to last year's fiery rhetoric, the government's tone will probably be more moderate this year, reflecting in part that the government is more experienced

and has a better appreciation of what it can and cannot do. The government is now more willing to talk to the private sector than it was for much of 2007, when it kept the business sector at arms length. Almost all of the economic cabinet changed in the course of 2007, and for the most part the new faces are less ideological and more pragmatic than the first batch, which should also help moderate the discourse. However, Correa will continue to set the economic agenda and policy, and will likely continue to unleash brash rhetoric from time to time. Furthermore, there will be a referendum on the new constitution in the second half of 2008, and likely national and local elections as well, which would also sustain continued rhetorical flourishes.

Legislative Changes

15. (C) Much of the change will be on the legislative front, as the Correa administration is requesting that the Constituent Assembly (CA) approve a number of laws governing the economy. The CA has already approved a new tax law and is currently reviewing a law to modify public sector finances and a "mandate" (a legal instrument that expires at the end of the CA) affecting the mining sector. Other laws that the government has mentioned that it intends to introduce include banking, mining, public sector enterprises, public sector procurement, labor, and competition. Additional laws might extend to investment and other sectors such as petroleum and electricity. The CA's focus on legislating rather than drafting a constitution is controversial, and it appears that the Correa administration has decided not to press forward with all of these bills. But eventual changes in the new constitution itself that affect the economic rules of the game comprise another area of uncertainty and worry.

16. (C) There are indications that for at least some of these laws, the changes could be relatively moderate. For example, on the banking law, the government has consulted with the banks, sought USAID and IDB assistance to review the draft law, and has shared the outline of its plans with the IMF and Embassy. The GOE has also consulted with the mining sector and sought Chilean and Canadian advisors for the mining law, and has asked for USAID support to review the competition law. However, even if the legislation is largely good, it could include problematic provisions (as did the draft tax law). The CA has little expertise or time to review the legislation, and appears disinclined to accept suggestions from the private sector. And even if the new laws as a whole are moderate, the fact that numerous changes are being made at the same time, with little review or lead time, will generate considerable uncertainty for the private sector and implementing challenges for both the government and business community.

Constitutional Changes

17. (C) The CA has to draft a new constitution by July. Thus far, the indications have been that the most significant economic changes will be handled legislatively rather than embedded in the constitution. But the constitutional drafting process has not been transparent thus far, so the final result could contain surprises.

Public Investment

18. (C) Another area where the GOE may have a notable impact during 2008 is public investment, as a series of investment projects move from planning to actual implementation. The government has significantly increased the investment budget for Petroecuador, in the hope of reversing the steady decline in production from its fields. The other area that should also see increased investment is the electricity sector, where several sizeable hydroelectric projects are close to the implementation stage. Other areas where the government hopes to address long-lingering problems by increasing

spending include health, education and transportation. However, government institutions are weak, and while investments will almost certainly increase over 2007, it is unlikely that implementation will be as fast and effective as the government would like.

¶9. (C) The increased spending raises questions about medium-term fiscal sustainability, but for the time being the government has considerable fiscal flexibility thanks to high oil prices and the petroleum reserve funds. In its baseline scenario the IMF calculates the government can cover its increased spending through 2011, although in a more pessimistic scenario, the GOE could face financing constraints in 2009.

Increased Central Government Control

¶10. (C) One trend that bears watching is the Correa administration's increased control over key economic institutions. In the second half of 2007, Correa appointees gained control over the largely autonomous Central Bank and Superintendency of Banks. With changes to the tax law and pending changes to public sector finances, the Minister of Economy will gain increased control over the previously rigid fiscal accounts. A forthcoming public sector enterprise law would seek to clarify the legal status of government corporations, many of which operate in a murky, poorly controlled limbo between the public and private sectors that promotes corruption and reduces accountability.

¶11. (C) These changes could improve government efficiency, but also give the central government increased political and economic leverage, and it remains to be seen how this new authority will be used. The financial controls will probably increase central government leverage over the large cities, which have been relatively autonomous. The new Central Bank team appears to be fairly technical, although their optimistic growth forecasts suggest that political factors do influence their calculations. In one instance, greater control by the Correa team played out in an unexpected way: after a Correa appointee took over as Superintendent of Banks she appears to have halted the Correa administration's plan to merge the Superintendency with the Central Bank.

Foreign Investment

¶12. (C) The government's treatment of foreign investors will continue to reflect the tension between the government's competing objectives. On the one hand, it realizes that it needs foreign investment to develop Ecuador's oil and mining resources, while on the other hand it wants to obtain a greater share of those resources for the state and increase the state's ability to monitor and regulate those sectors.

¶13. (C) On the petroleum side, the government is seeking to renegotiate contracts with five foreign oil consortiums, find private companies that are willing to rehabilitate Petroecuador's mature fields, and negotiate a contract with a U.S./Canadian company to invest \$2-6 billion to develop Ecuador's extra heavy oil field. On the mining side, the GOE has talked about terminating some concessions but in practice appears to want to renegotiate with a number of the larger foreign companies with important finds. In those negotiations, the government has generated additional leverage for itself by threatening to impose a 99% windfall oil income tax or to terminate mining concessions, but it does not seem anxious to actually impose those measures.

¶14. (C) A big question mark is whether the government negotiators will have sufficient guidance and authority to make meaningful progress in these complex negotiations. Early indications were that they did not, but they might obtain clearer instructions from Correa over time. Challenges include agreeing on a new contractual framework, new financial conditions, and international arbitration provisions (since the GOE does not want to accept ICSID

jurisdiction). The GOE also needs to establish how the new 70% windfall income tax will apply to the new contracts (the 99% tax applies to existing petroleum contracts, while the 70% tax is established in the new tax law approved at the end of 2007, and applies to new oil and mining contracts).

¶15. (C) The other investment dispute affecting U.S. companies involve government arrears to U.S. electricity companies. The new rules the government is seeking for public sector finances and public sector enterprises might give it more flexibility to address this problem.

¶16. (C) Other U.S. investors, as noted in reftel, face a range of concerns that do not rise to the level of investment disputes. The government, to the extent it pays attention to these other companies, tends to view them as employers and representatives of a particular sector, and does not appear to view them from the optic of foreign or U.S. investors.

COMMENT

¶17. (C) The government has an ambitious agenda for this year, and some change will happen. The question is how much and in what direction? Given the practical constraints on the number of changes that can be approved by the Constituent Assembly and the government's limited administrative ability, parts of the government's agenda will not be implemented this year, but we do not know which parts might slip.

¶18. (C) Some of the changes could be helpful: Ecuador would benefit from good competition and government procurement laws, the IMF noted that many of the banking and fiscal reforms the government is proposing are consistent with IMF recommendations, and Ecuador needs to invest in physical and social infrastructure. Some of the changes could be harmful, for example, if the oil and mining contract renegotiation is heavy-handed or the government misuses its additional economic authority. Probably many reforms will contain a combination of both. We will not know the balance until details of the reforms are released, but we've seen indications that the GOE has been relatively pragmatic in putting together some of its proposals.

¶19. (C) Even with an optimistic scenario, uncertainty will remain high in 2008, continuing to suppress private sector investment. It remains to be seen whether the package the government is trying to implement will bring greater certainty and confidence for 2009. Meanwhile, high oil prices and continued decent performance by Ecuador's non-oil exports are giving the Correa government a buffer and time to move forward with its economic package, although Ecuador's growth is lagging that of its neighbors.

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